STATE STREET

Stefan M. Gavell
Executive Vice President and Head of
Regulatory and Industry Affairs

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, MA 02111-2900

Telephone: 617.664.8673
Facsimile: 617.664.4270
smgavell@statestreet.com

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Via email: regs.comments@federalreserve.gov

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Proposed Rule -- Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (Docket No. 1438 and RIN 7100–AD–86)

Dear Ms. Johnson:

State Street Corporation appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System (the "Board"), with respect to the notice of proposed rulemaking (the "Proposed Rule") that would implement the enhanced prudential standards required to be established under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Act") and the early remediation requirements established under section 166 of the Act.

Headquartered in Boston, Massachusetts, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With $23.208 trillion in assets under custody and administration and $1.993 trillion in assets under management at March 31, 2012, State Street operates in 29 countries and more than 100 geographic markets. State Street is organized as a financial holding company and conducts operations through several entities, primarily its wholly-owned bank subsidiary, State Street Bank and Trust Company.

State Street supports the systemic risk mitigation purposes of Section 165 of the Dodd-Frank Act, and we support many aspects of the Proposed Rule.

We have significant concerns, however, with certain provisions of the Single Counterparty Credit Limit (the "SCCL") proposal, particularly as they relate to traditional custodial bank activities, such as securities lending[1], placements with central banks, the acceptance of non-U.S. sovereign debt as collateral, and support for the global securities payment and settlement processes. As described below, the treatment of these activities under the Proposed Rule is inconsistent with existing regulatory frameworks and industry credit risk management practices, creating a high likelihood that, without significant changes, the SCCL proposals will increase, rather than decrease, systemic risk, and create unnecessary competitive disadvantage for U.S. banks operating in global financial markets.

We strongly urge the Board modify its SCCL proposal to address the unique and significant issues the Proposed Rule raises for U.S. custody banks.

Our comments today focus on our significant concerns with the SCCL. While we are generally supportive of the Proposed Rule in other areas, we also provide some suggestions on how they may be improved as well. Our detailed comments follow.

Single Counterparty Credit Limit

Overall Comments

State Street supports the purposes of Section 165(e) of the Dodd-Frank Act, which directs the Board to issue rules to establish a new SCCL for systemically important bank holding companies. Prior to Dodd-Frank, existing national or state single borrower limits applied at the bank, not holding company, level. In addition, Section 165(e) is broader in scope than the previous bank-level limits, expanding the types of credit exposures covered to include those resulting from derivatives, securities lending and repo transactions.[2] While State Street appreciates the potential systemic risk mitigation benefits of both the holding level company requirement and the broadened definition of credit exposures subject to the limit, we have significant concerns with the Proposed Rule's implementation of Section 165(e), which we fear is unworkable in some areas, and grossly exaggerates credit risk in others.

The Proposed Rule would implement Section 165(e) and establish the methodology for calculating exposures subject to the SCCL. Unfortunately, for credit exposure resulting from securities lending activities, the Proposed Rule ignores numerous economic characteristics of securities lending arrangements. As a result, the methodology of the

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[1] While our comments today focus most specifically on securities lending, they apply more generally to the range of similar activities, such as those defined under Regulation Y as "repo-style transactions" ("a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the bank holding company acts as agent for a customer and indemnifies the customer against loss.") or under Basel III as a "securities financing transaction" (" repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on the market valuations and the transactions are often subject to margin agreements.") Our recommended changes apply to the treatment of these similar transactions as well.

[2] Section 610 of Dodd-Frank similarly amends the national bank lending limit to include credit exposure resulting from derivatives, securities lending and repo activities; Section 611 requires state-level lending limits to consider derivative exposures.

Proposed Rule grossly overstates the credit exposure associated with securities lending transactions, and would severely constrain securities lending markets.

The Proposed Rule's failure to provide an exemption for high-quality non-U.S. sovereign exposures is similarly flawed. Exposure to such non-U.S. high-quality sovereigns are an integral part of State Street's global business and risk-management model, and are, in fact, often required by local regulators. As with the U.S. Federal Reserve, short-term placement of funds with non-U.S. central banks are essential to sound risk management practices for global custodians, and, as with U.S. Treasuries, high-quality non-U.S. sovereign bonds are typically accepted as collateral for securities lending and other transactions outside the U.S.

Other provisions of the SCCL proposal also would benefit from revision. The definition of "control" used to determine a covered company's affiliates, and to determine which counterparties must be aggregated under the limit, is unworkable. The proposed treatment of collateral fails to recognize the unlikelihood of "double default", and overstates risk to the collateral issuer. In other areas, such as the treatment of unexpected breaches of the SCCL due to securities payment or settlement activity, the proposal could impair the smooth functioning of securities settlement systems, with the risk of disruption to global financial markets.

Overall, as proposed, the SCCL could significantly limit the ability of global custodians, such as State Street, to provide traditional custody services. The result would be an increase in global systemic risk, and a significant competitive disadvantage to U.S. banks in the global marketplace.

In general, we note that the credit concentration limits under Section 165 is only one element of the ongoing overall regulatory and industry efforts to mitigate systemic risk, and address systemic issues revealed during the financial markets crisis, both in the United States (largely through the Dodd-Frank Act), and globally, where the Financial Stability Board and the European Union are pursuing an aggressive systemic risk mitigation agenda. The SCCL should be viewed as one piece of the overall regulatory approach to systemic risk, not as a solution to all potential systemic risk issues, and the cumulative impact of these various measures should be evaluated in terms of their impact on financial markets and end-users.

As noted above, we support the goals of Section 165(e), and believe that, properly implemented, the new SCCL will benefit the U.S. financial system. We urge the Board to make the changes suggested below.

Measurement of Credit Exposure for Securities Lending[3]

State Street and other custody banks have long provided agency securities lending services to their custody clients. Under these arrangements, beneficial owners of

[3] State Street fully supports similar comments by the Joint Custody Banks (The Bank of New York Mellon Corporation, Northern Trust Corporation and State Street Corporation) and the RMA filed on April 30, 2012.

securities, such as pension funds or mutual funds, can generate additional revenue through short-term lending of securities to other market participants. The lending of securities through these custodial programs are overcollateralized with cash or other high-quality collateral, and the custody banks often provide an additional layer of protection to lenders by indemnifying for amounts required in excess of the value of collateral received to purchase the loaned securities in the event of a borrower default. As with existing capital rules, we assume this indemnification will be treated similarly to a principal lending exposure, and therefore be subject to the SCCL. We do not object to including potential exposures resulting from indemnifications under the SCCL, but have significant concerns with how these exposures are calculated under the Proposed Rule.

For many years, State Street has calculated exposures resulting from our agency securities lending business using various iterations of a simple Value at Risk (VaR) model, both as an internal measure of credit utilization (since the mid-1990s), and for regulatory capital purposes (following Board approval of the methodology starting in 2003). The Board initially approved use of a simple VaR methodology for securities lending under Basel I. Similar methodology was later approved by the Basel Committee, and incorporated into Board, OCC, OTS, and FDIC regulations as part of Basel II.

The Proposed Rule abandons these regulator-approved credit risk measurement methodologies and reverts to a standardized "look-up" table for determining credit exposure resulting from securities lending.

Under the proposal, credit exposure from a securities lending transaction would be equal to the difference between:

1) the value of the securities lent, plus a standardized volatility adjustment and
2) the value of the collateral accepted, less a standardized volatility adjustment.

A further adjustment would apply in cases where the currency denomination of the securities lent differs from that of the collateral received.

The proposed methodology is severely flawed, for several reasons:

- **Lack of risk sensitivity** --- the standardized volatility factors are insufficiently granular, are not based on empirical data and do not take into account the tenor of the loan;
- **10-day liquidation period** --- the Proposed Rule assumes a 10-day liquidation period for securities lending transactions, versus the industry and regulatory standard of five days.
- **No recognition of correlation** --- the Proposed Rule incorrectly assumes the potential volatility of similar securities on loan and accepted as collateral are uncorrelated, and that their market value would move in opposite directions in times of stress.
- **Very limited recognition of netting** --- The Proposed Rule does not properly recognize the diversification and risk mitigation benefits of netting sets used in

the VaR methodology, which are underpinned by legally enforceable netting agreements.

As a result of these factors, the Proposed Rule would result in a measurement of credit exposure resulting from securities lending many multiples in excess of those estimated by well-established credit and regulatory capital methodologies. The result will be a significant contraction of securities lending markets, denying beneficial owners of securities the ability to increase revenues while also reducing market liquidity by reducing the supply of securities available to offset settlement fails, and for use in hedging and other strategies.

We strongly urge the Board to reconsider its proposed approach to securities lending under the SCCL, and adopt a measurement methodology that is aligned with existing regulatory capital requirements. While covered companies not active in the securities lending markets should certainly be offered the option of using the proposed "look-up" table approach, firms that have made, under the supervision of the Board, extensive, multi-million dollar investments in the development of VaR-related methodologies, for both regulatory capital and risk management purposes, should be permitted use these same methods for measuring credit exposure resulting from securities lending activities under the SCCL. In addition to resulting in a more accurate measure of the economic risk posed by securities lending activities, permitting the use of the full range of regulatory capital methodologies would better align U.S. rules with similar rules in the EU, reducing competitive disadvantage for U.S. firms, and eliminating the need for covered companies to implement, at significant costs, duplicative and redundant systems for measuring essentially the same risk.

While alignment with existing regulatory capital methodologies is the most effective means to implement Section 165(e) with respect to securities lending, it is possible that other alternatives may be designed to address the four key factors listed above. The Board could, for example, permit the use of a simple VaR, but specify standardized supervisory inputs for certain factors, such as volatilities and correlations, that represent observable data, as well recognition of legally enforceable netting agreements. While such an approach would be less risk sensitive than following existing regulatory capital models, and would unnecessarily create a duplicative and costly risk measurement infrastructure solely for the purposes of Section 165(e), it would be a better alternative than the treatment proposed for securities lending in the Proposed Rule.

Treatment of Foreign Sovereigns

State Street opposes the treatment of exposures to high-quality non-U.S. sovereign counterparties under the Proposed Rule.

Under the Proposed Rule, exposures to the U.S. government are exempt from the SCCL, but exposures to other sovereign counterparties are not. Credit exposures to non-U.S. sovereigns, including placements with non-U.S. central banks and holdings of non-U.S. sovereign debt securities, will be subject to the SCCL limits, significantly limiting the ability of globally active covered companies to prudently manage risk, comply with non-U.S. regulatory requirements and provide numerous capital markets-related services outside of the U.S.

The Proposed Rule's treatment of non-U.S. sovereigns would disrupt global financial markets in several areas relevant to custody banks.

First, limiting our ability to hold non-U.S. sovereign debt would reduce our ability to prudently manage our investment portfolio. A custody bank's liability-driven balance sheet requires high levels of investment in liquid, high-quality securities, including non-U.S. sovereigns. Custodial banks generate deposits in many different currencies, as a by-product of client investment activities, and currency-matching of these deposits through central bank placements or by purchasing same current sovereign debt is consistent with a conservative approach to balance sheet management.

Second, custody banks, as a part of their ordinary course of business, frequently hold excess temporary liquidity, resulting from large deposit balances by customers in connection with securities settlement or payment activity. To manage these exposures, State Street frequently places this short-term excess liquidity with non-U.S. central banks, typically in the jurisdiction in which the funds are denominated. Limiting our ability to place funds with non-U.S. central banks would require converting the funds to U.S. dollars and placing them with the Federal Reserve, adding an extra level of complexity and foreign exchange risk to the management of this excess liquidity.

Third, the Proposed Rule would limit our ability to accept non-U.S. sovereign debt as collateral in connection with financial markets transactions. For State Street, this limitation would be particularly significant for our non-U.S. agency securities lending and foreign exchange businesses, where using non-U.S. sovereigns as collateral is standard practice. The market preference for use of government securities as collateral has been reinforced by Basel III rules which favor the use of such collateral. Limiting U.S. banks' ability to accept non-U.S. sovereign debt as collateral in relation to derivatives transactions would also frustrate progress toward the global regulatory priority of moving away from bilateral swaps to a more centrally cleared swaps market.

Under the Proposed Rule, U.S. agency lenders approaching the SCCL for a non-U.S. sovereign would be required to either reduce the size of their non-U.S. agency lending activity (to their competitive disadvantage), or reject high-quality sovereign collateral in favor of relatively lower quality collateral, which would be inconsistent with their duties as agent lenders. As a result, it is likely that such activity will move to either non-U.S. institutions that use different measurement methodologies with respect to concentration risk, or to other institutions that do not possess the systems, controls or personnel to manage the attendant risks. Neither outcome will reduce systemic risk and both are contrary to sound risk management practices.

Fourth, the Proposed Rule contradicts increasingly common non-U.S. liquidity regulations, which typically require local affiliates of U.S. firms to hold certain levels of local sovereign debt.

Finally, as a general matter, the extraordinary bias created in the Proposed Rule against exposure to high quality foreign sovereign credits would have adverse systemic implications, by adding to contagion risk as covered companies swap out non-U.S. currencies at any price which would reduce liquidity in the markets and cause market indicators of systemic risk, such as FX basis swaps and Libor OIS spreads, to become elevated.

As a result, we strongly urge the Board to provide an exemption for high-quality sovereigns, based on the following criteria:

1) Exempt all foreign sovereigns with a OECD Country Risk Classification of 0, with the exception of sovereigns that:
    a. have defaulted on any exposure during the previous five years;
    b. are currently participating in an IMF supported financial assistance program; or
    c. are not traded in an active two-way market with high trading volumes.[4]
2) Exempt all central banks in countries meeting the criteria above.

While the proposal above would exempt a group of non-US sovereigns from the SCCL, it would not eliminate Board oversight of exposures to such sovereigns, which would continue as part of the Board's supervision of covered company's risk management processes.

Exception for Temporary Custody or Operational Exposures[5]

Custody banks play a key role in the smooth functioning of global financial markets by facilitating payments in relation to the settlement of securities, foreign exchange, derivative, commodity and other market transactions.

As part of this custodial function, custody banks provide temporary liquidity to market participants, extending, for example, provisional credit to institutional investors to smooth timing differences between the making and receiving of payments in connection with the settlement of a securities transaction, or providing overdrafts in relation to securities settlement delays or fails. Such extensions of credit are typically intraday, but can extend multiple days as well. These provisional extensions of credit may be large,

[4] These conditions would make the Proposed Rule congruent with the recent Board Notice of Proposed Rulemaking on Risk-Based Capital Guidelines: Alternatives to Credit Ratings for Debt and Securitization Positions (76 Fed. Reg. 79380); European Central Bank Decision ECB/2012/4 (March 21, 2012); and the liquidity risk management criteria of Section 165(c) of Dodd-Frank, respectively.
[5] For more detailed discussion, see Joint Custody Bank comment letter filed by The Bank of New York Mellon Corporation, Northern Trust Corporation, and State Street Corporation on April 30, 2012.

but are always short-term, and are typically secured by a lien on the assets of the institutional investor.

Similarly, custody banks may receive excess liquidity from market participants, through deposits from institutional investors related to securities sales, income received, or other operational activities. Such excess liquidity is typically placed by custody banks on a short-term basis with central banks, in both the U.S. and other jurisdictions.

Both of these circumstances --- extensions of credit related to payment or settlement activity, and excess liquidity --- may create instances where a custody bank may risk approaching or exceeding the SCCL under the Proposed Rule. For custodian extensions of credit, the size of the extension of credit, while small relative to the size of the fund, may be sufficiently large, combined with other exposures subject to the SCCL, to temporarily exceed the 25% threshold --- not only creating the risk of breaching the SCCL, but also limiting covered companies' ability to provide intraday credit, in order to avoid even the chance of a day-end breach.

For excess liquidity, the placement of funds with non-exempt central banks (*i.e.*, all central banks except the U.S. Federal Reserve) would need to be aggregated with other sovereign exposures under the SCCL.[6]

As described in more detail in the Joint Custody Bank comment letter, the ability of custodial banks to provide these types of credit exposures is essential to smooth functioning of the global payment and settlement system, and there is ample regulatory precedent for treating these short-term, operational exposures differently than other credit exposures.

As a result, we urge the Board to adopt an additional exception under the SCCL that would exclude credit exposure to a counterparty provided that:

(i) The exposure arises in the normal course of providing payment or settlement services for investment-related transactions, including foreign exchange, securities, derivatives, commodities and similar transactions;

(ii) The covered company has policies and procedures that appropriately govern the credit and liquidity risks of the counterparty, exposures related to payments and settlements, and that monitor exposures daily;

(iii) To the extent that the aggregate exposure to the counterparty exceeds the SCCL, the covered company takes appropriate action, consistent with safety and soundness considerations, to reduce the excess exposure as quickly as reasonably practicable and in any event within ten business days of the day the excess first occurred; and

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[6] See page 5 for more detailed discussion of our concerns with treatment of non-U.S. sovereigns.

(iv) The covered company reports the excess exposure to its primary Federal regulator not later than the first business day after the excess occurs, and advises as to actions it has taken or will take to eliminate the excess exposure consistent with the ten business day timeframe specified above.

Definition of "Control"

State Street is concerned that the definition of "control," for purposes of determining the aggregation requirements for both covered companies and counterparties, is, as proposed, overly expansive, and in many circumstances unworkable.

For the aggregations of affiliates of covered companies, we are concerned that the proposed 25% standard would capture a broad range of joint ventures or other arrangements where a covered company may only hold a minority interest. The credit utilization systems of such joint ventures are typically not integrated into those of minority owners, creating significant administrative challenges, and would result in "double counting" of exposures.

For aggregation of counterparties subject to the SCCL, we are concerned that, in many circumstances, covered companies will not have sufficient data available to identify controlled counterparties under the proposed criteria, making the Proposed Rule unworkable. While we are generally comfortable that we could identify entities under control in, for example, traditional lending arrangements where we have a contractual arrangement with our counterparty, the Proposed Rule would require covered companies to aggregate exposures in many cases where no such contractual relationship exists. The collateral substitution provision, for example, would require covered companies accepting collateral to evaluate the issuer of collateral accepted, and aggregate the resulting credit exposure with any other exposure to firms meeting the Proposed Rule's definition of common control. Similar issues arise in other areas of the rule, due to the expansion of the definition of credit exposure to include many capital markets, vs. traditional lending, exposures. In these circumstances, covered companies need to be able to rely on publicly available data to determine commonly controlled counterparties subject to aggregation under the SCCL. There is no such data source for minority interests.

To the extent that the definition of control under the SCCL diverges from existing industry credit or regulatory practices, we are concerned with the impact of the additional compliance burden, particularly as it compares to the negligible systemic risk mitigation benefits achieved from such an expansive definition of control.

As a result, as a general matter, we urge the Board to revise its definition of control for purposes of the SCCL to include only those entities that are consolidated with the relevant company for financial reporting purposes, <u>and</u> in which the relevant company owns a majority interest of voting shares. A standard focused on financial reporting will provide covered companies a public, verifiable, continuously available means of determining common control.

While we believe a financial reporting consolidation standard would be the most effective means of defining common control for purposes of the SCCL, there are circumstances that arise where entities might be consolidated for financial reporting standards, but which are not interconnected from a risk standpoint and on which we do not rely in making credit decisions.

For example, U.S. and U.K. asset-backed master trusts would meet the definition of a controlled subsidiary of a covered company under the Proposed Rule. Such trusts are consolidated with their sponsors for financial reporting purposes due to the sponsor's material ownership of the trust's seller share in the securities issued by the trust and not because such sponsor has any legal obligation to financially support such entities. Such entities tend to be very large, with sufficient and stable cash flows to operate quite independently and are structured to be bankruptcy remote, with terms that increase the rights and cash flow to senior security holders in the event of performance deterioration or sponsor/servicer insolvency. While consolidated under GAAP, such investments in securities backed by such trusts do not constitute true economic credit exposures to their sponsors or servicers, and should be excluded from any SCCL definition of control. We request the Board provide confirmation that, despite the financial accounting consolidation of these trusts by their sponsors, credit exposure resulting in investment in securities of such trusts need not be aggregated with their sponsors for purposes of the SCCL.

In relation to investment funds, State Street supports the "arm's length" treatment provided under the Proposed Rule for funds and other vehicles sponsored or advised by covered companies, and agrees that such funds should not be aggregated with their sponsor or advisor for purposes of the SCCL. We are unsure, however, how the proposed control test would be applied in certain non-U.S. jurisdictions where the legal construct of fund families does not, unlike the U.S., establish each investment fund as a separate legal entity. The foremost example of this is in traditional common law jurisdictions where funds established as trusts do not have a separate legal identity from the trustee of the fund. A trustee may act in that capacity for a number of funds, although generally the assets of one fund are not subject to the claims of the creditors of another fund supported but the same trustee. Examples also exist in certain civil law jurisdictions, where contractual form investment companies have no separate legal identity and the manager holds the assets for the funds. We request that the Board provide guidance allowing covered companies sufficient flexibility to adopt reasonable interpretations, subject to supervisory review, of the applicability of the control definition to such non-U.S. fund structures.

Furthermore, the Proposed Rule requires the municipalities, agencies and instrumentalities of states and other sovereign entities to be aggregated with their respective sovereigns regardless of whether or not such sovereigns have a legal obligation to support such entities. Current credit analysis and monitoring practices generally avoid such aggregations unless the underlying entity is materially reliant on its sovereign for financial support.

Finally, State Street does not aggregate private pensions with their sponsors, as we do not rely on such sponsors for credit support, looking only to the pension's underlying assets, as such support is reserved only for plan beneficiaries, if at all in the case of defined contribution plans.

In these cases, and in others, covered companies will be required to develop monitoring capabilities separate from those developed in consultation with our regulators for credit risk management purposes. Such monitoring system development needs would extend beyond the creation of parallel computer programs designed to aggregate such exposures. It would require the wholesale collection of customer data not currently collected to amass the numerous data points that would be required to aggregate exposures properly. All of these changes create cost and operational burdens that will serve only to raise the cost of the crucial services we provide to market participants, with little or no offsetting systemic risk mitigation benefits.

On a related matter, for purposes of the SCCL, State Street assumes that securities backed by student loans that are 97% or more guaranteed by the U.S. Department of Education under the Federal Family Education Loan Program (FFELP) would be considered U.S. government exposures, at least to the extent the underlying loans are guaranteed, for purposes of the SCCL. The securities backed by such loans are often also issued by discrete trusts and consolidated for financial reporting purposes on the balance sheet of the seller/servicer. Such seller/servicers can be either private (*e.g.*, SLM Corporation and Nelnet Inc.) or public (*e.g.*, Kentucky Higher Education Student Loan Corporation). They can also be quite large, due in part to the low risk of these securities and the scale economies needed to service them properly, so the treatment may add considerably to SCCL constraints and, by extension, market liquidity and costs. We request confirmation that the credit exposure resulting from holding such securities would, to the extent the underlying loans are U.S. government guaranteed (*e.g.*, 97% or more), be considered U.S. government exposures, not exposures to the seller/servicer.

Central Clearinghouses

As mentioned in the preamble to the rule,[7] the Proposed Rule's inclusion of initial margin, excess variation margin and guarantee fund contributions provided to a derivatives central counterparty ("CCP") is at odds with other global and U.S. policy initiatives intended to shift the substantial portions of the global swaps market from bespoke bilateral contracts to a standardized, centrally cleared environment. State Street is concerned that subjecting exposures to CCPs to the SCCL will substantially frustrate global regulatory efforts to accomplish this goal and significantly increase systemic risk by further limiting the number of financial institutions that are able to provide access to these clearing services.

CCPs are subject to substantial regulatory oversight, and are intended to reduce risks inherent to bilateral swap contracts by substituting the performance of the CCP for that of

[7] See Question 39

the original swap counterparties. Most counterparties, particularly end-users, will not be in a position to become CCP members, and will rely on futures commission merchants (FCMs) to clear trades through the CCP. Such FCMs would typically be "covered companies" for purposes of the Proposed Rule, so subjecting exposures to the CCP to the SCCL would necessarily limit their ability to provide clearing services. This problem will be particularly acute during the early stages of the new swaps regulatory regime, when the number of both CCPs and FCMs will be necessarily limited.

State Street is concerned that including exposures to CCPs under the SCCL will significantly slow the global movement toward central clearing, resulting in an increase, rather than decrease, in systemic risk. As a result, we urge the Board to adopt an exclusion for exposures to CCPs from the SCCL, perhaps conditioned on suitable criteria ensuring that such CCPs are subject to appropriate regulatory oversight.

Treatment of Collateral

While State Street's primary concern with the proposed "substitution" of credit risk to the issuer of collateral under the SCCL relates to the non-U.S. sovereign issue described above, we have more general concerns with the approach to collateral in the Proposed Rule as well.

First, the proposed "substitution" approach represents a significant departure from existing industry and regulatory practice in this area, and will require substantial investment in new systems and processes to implement.

Second, the Proposed Rule fails to recognize the unlikelihood of "double default" inherent to measuring credit risk related to collateral. While this effect can vary depending on the correlation between the exposure and the collateral, by failing to reflect the substantially lower probability of a joint default of both the original counterparty and the issuer of collateral, and instead simply requiring collateral to be counted against the issuer at the "adjusted market value," the Proposed Rule's "substitution" approach overstates credit risk to issuers of collateral.

Third, we note that the Proposed Rule's collateral "substitution" requirement is not required by Section 165(e) of the Dodd-Frank Act, and was added to the Proposed Rule on the Board's own initiative.

For these reasons, State Street suggests the Board defer rulemaking requiring collateral substitution to a later date, after the Dodd-Frank mandated requirements of the Proposed Rule have been implemented, and after the Board consults further with covered companies on the issue.

Money Market Mutual Funds

The Proposed Rule raises the possibility that certain investment funds, particularly money market mutual funds, could receive sufficient implicit support from sponsoring covered companies that they should be aggregated with their sponsor for purposes of the SCCL.[8]

State Street strongly disagrees with this suggestion. Money market mutual funds are highly regulated by the Securities and Exchange Commission ("SEC"), which adopted significant revisions to the rules governing such funds[9] in 2010 to address the liquidity pressures faced by some funds during the recent financial crisis. Further, money market mutual fund reforms are currently under consideration by the SEC, and are the focus of considerable attention by the U.S. Financial Stability Oversight Council ("FSOC") and the global Financial Stability Board. We do not believe Section 165(e) was intended by Congress as a substitute for SEC regulation of money market mutual funds, and we urge the Board to continue to work with the SEC, through the FSOC, on appropriate regulation of such funds.

Attribution Rule

State Street agrees with the language in the preamble to the Proposed Rule noting that "an overly broad interpretation of the attribution rule in the context of section 165(e) would lead to inappropriate results and would create a daunting tracking exercise for covered companies," and with the conclusion reached by the Board that it should "minimize the scope of application of this attribution rule consistent with preventing evasion of the single-counterparty credit limit."

To ensure consistent application of the Board's views related to the attribution rule, we suggest specific language focusing the attribution rule on evasion of the SCCL be added to the text of the final rule.

Effective Date

As noted above, numerous provisions of the Proposed Rule, particularly the provisions related to collateral substitution and the inclusion of several types of exposures previously not subject to national bank and state lending limits, are a significant change from existing industry and regulatory practices, and will require substantial systems and other changes by covered companies. We are concerned that the proposed effective date of October 1, 2013 will not provide covered companies sufficient time to implement the changes necessary to comply with any final rule.

As a result, State Street requests the Board to use the discretion provided under Section 165(e), and extend the effective date until July 21, 2015, the maximum allowable transition period permitted under Section 165(e).

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[8] Question 24
[9] SEC Rule 2a-7

Other Comments

Capital and Leverage

State Street broadly supports the first phase of the Federal Reserve's proposed enhanced risk-based capital and leverage requirements for covered companies, involving the application of a uniform capital plan rule and adherence to minimum risk-based capital requirements.

Our concerns relative to the Proposed Rule primarily relate to the second phase of the Federal Reserve's approach. As an initial matter, we note that the G-SIB capital framework, intended to define a quantitative risk-based capital surcharge for covered companies, is primarily designed for global universal banks and may therefore not properly accommodate other industry business models. Moreover, we believe that robust recovery and resolution planning may ultimately better address supervisory concerns than a specific capital surcharge, particularly with respect to custody banks. Similarly, we are concerned with the prospect of additional, burdensome oversight and reporting requirements that may, over time be associated with the G-SIB designation, including measures that do not reflect the financial activities and risk profile of custody banks.

From a Basel III perspective, we emphasize our concerns relative to the capital treatment of mark-to-market losses on available-for-sale securities (AFS) for firms subject to U.S. GAAP. The requirement under U.S. GAAP to deduct unrealized losses and add unrealized gains to regulatory capital has a number of significant negative implications for banks, including enhanced capital volatility, the need for additional unwarranted capital buffers and constraints on the use of various asset-liability management tools. We also note the important level playing field implications of this matter, since it will not impact banks subject to IFRS based on currently proposed accounting changes.

In order to address this issue, we strongly recommend that the FRB allow banks to add unrealized mark-to-market losses (and subtract unrealized mark-to-market gains) on AFS securities back to regulatory capital, or alternatively, to allow such treatment for the high quality assets that banks must hold to meet the liquidity requirements of the Basel III Accord.

Liquidity

State Street generally supports the Board's proposed approach for strengthening the liquidity profile of covered companies, specifically the introduction of enhanced liquidity risk-management standards, and at a later date, the establishment of an internationally harmonized framework for liquidity risk management. We believe that the envisioned framework, including stress testing requirements, the maintenance of a buffer of high-quality liquid assets, and the development of contingency funding plans, are well-founded, consistent with industry best practices and are likely to prove effective in addressing weaknesses in liquidity management that may exacerbate financial crises. We also welcome the principles-based focus of the Board's approach, and the clarity that is provided relative to the use of the liquidity buffer in times of stress.

State Street strongly supports the approach adopted by the Board for defining securities eligible for inclusion in the required liquidity buffer. We note in particular the incorporation, subject to appropriate haircuts, of agency MBS, as well as other high-quality assets that meet certain specified criteria. In our view, this approach is far preferable to the Basel III liquidity framework as currently proposed, since it effectively addresses several of its most significant weaknesses, notably the definition of LCR eligible assets and certain overly severe draw-down and run-off assumptions. We therefore urge the Board to continue to work with their U.S. and global Basel Committee peers to improve the intended Basel III LCR via the adoption of an approach that is consistent with the Proposed Rule.

Notwithstanding our general support for the Board's proposed approach, we believe that there are several matters that may benefit from adjustment or clarification.

First, we have reservations regarding the prescriptive approach proposed by the Board relative to the responsibilities of the Board of Directors of a covered company in respect of liquidity management. Consistent with SR 10-6, The Interagency Policy Statement on Funding and Liquidity Risk Management, we recommend more flexibility in the assignment of responsibilities between the Board of Directors and senior management to promote "effective corporate governance consisting of oversight by the board of directors and active involvement by management in an institution's control of liquidity risk". While it would be appropriate for the Board of Directors to ensure that a rigorous monitoring and escalation process is in effect, it is important not to supersede the role of management in the covered company's normal commercial operations within the risk appetite established by the Board of Directors.

Second, we believe that requirements relative to cash flow projections should be sufficiently flexible to accommodate the different business models and activities that prevail among covered companies. This includes custody banks, whose asset base, balance sheet strategy and risk profile are broadly dissimilar to those of other large U.S. financial institutions.

Third, we believe that the proposed requirement to regularly review the liquidity profile of business lines may be more burdensome than necessary to achieve the goals of Section 165, particularly when coupled with existing best practices relative to new product approvals, funds transfer pricing and RAROC which are designed to align the risk-taking incentives of individual business lines with the liquidity risk exposure of the institution as a whole. We believe the Proposed Rule could be improved through the introduction of a materiality standard, so that a full review of the liquidity profile of business lines is reserved for those which are either higher risk or which have undergone significant change.

Fourth and consistent with SR 10-6, the, we believe that it is important for the Board not to mandate diversification within ancillary funding sources simply for the sake of diversification. As an example, if a covered company's wholesale funding represents only a small amount of its overall balance sheet and there is an ample liquid asset buffer, there should be no absolute requirement to diversify counterparty exposure within that category. In our view, such an approach would offer little to no incremental liquidity benefit.

Finally, and in response to Question 12, we note our strong opposition to the development for covered companies of an additional limit on short-term debt. In our view, a short-term debt limit represents a narrow 'one size fits all' approach that does not readily accommodate different business models, financial activities and risk profiles. It also offers no real risk reduction benefits beyond the enhanced liquidity risk-management standards and the quantitative liquidity requirements that define the FRB's intended approach.

Stress Testing

Overall, State Street believes that credible and thorough stress tests can be useful tools for capital planning and can provide useful capital adequacy information to market participants and regulators.

State Street does, however, have three main concerns with the Proposed Rule, related to scenario development, disclosure and the timing/frequency of the requirements.

For scenario development, we believe that the requirement to have two separate scenarios (adverse and severely adverse) for both Supervisory and Company specific analyses is unnecessary and unduly intrusive. We suggest the Board require one adverse scenario for both Company specific and Supervisory results, which would be sufficient to measure capital adequacy.

For disclosure, we support the company-specific disclosures by the Board, which, provided the disclosures are done appropriately, have an overall benefit to investors and other interested parties. In our view, however, these disclosures should be high-level, and aimed toward providing an overall view of the condition of the banking system, and should not suggest that banking organizations should manage to these highly unlikely scenarios.

We are more concerned by the potential implications of individual company disclosure, which we fear could create unwarranted confusion in the marketplace. For example:

- Public disclosure of company results could be subject to misinterpretation, particularly in the areas of scenarios in which the likelihood or plausibility of the scenario may be extremely remote.

- To the extent scenarios and results differ between the Supervisory stress test and the Company stress test, there could be needless debate about the appropriateness of the hypothetical scenario selection.
- To the extent that loss estimates differ under similar scenarios, the user may not fully understand the intricacies of using detailed product-specific models (Company) versus cohort level analysis (Supervisory).

With regard to timing and frequency of stress tests, we believe it would be more appropriate to perform the test as of June 30 of each year, to allow for process feedback in advance of a company's annual reporting process. Any pertinent disclosure could be integrated into this process. In addition, we note that the outcome of this exercise is clearly aligned with the Company's goal setting process and related communications, such as dividend expectations, capital actions and potential merger and acquisition plans. To the extent this information is available as part of the year-end communication process, we believe this would be beneficial to investors.

The process timeline should include adequate turn-around time for the necessary review and independent validation of models and methodologies supporting estimates. To the extent such information is expected to be furnished to the Board, the timeline should be outside of the year-end reporting process to optimize resources dedicated to the process. We also believe the process should leverage the on-site examinations performed by the resident examiners.

Finally, we suggest the Board reconsider requiring the publication of two stress tests annually. We believe a more appropriate update would entail the discussion of the company's risk profile, financial condition and overall business. We believe this could be handled in the form of a semi-annual update analysis rather than a full scale stress test. To the extent there were material changes to the business, we believe the rules would require a re-submission of stress testing and therefore negates the need for the update.

Once again, State Street appreciates the opportunity to comment on this highly significant proposal. As noted above, our most significant concerns relate to the proposed SCCL, which we believe significantly overstates the credit exposure resulting from indemnified agency securities lending transactions, treats high-quality non-U.S. sovereign exposures improperly, and does not provide a suitable exception for exposures resulting from operational or custodial activities. We urge the Board to adopt the changes described above.

Please feel free to contact me with any questions.

Sincerely,

Stefan M. Gavell